

Is it always *Quality versus Quantity*?



Quality and Quantity, Subjective versus Objective, often seem to find themselves being pitted against one another. We will examine both through the lens of which markets are ‘best’ for trend and hopefully also demonstrate that it is possible to reconcile these two opponents and persuade them both to work together. Indeed, distilling ‘trend’ into “trend quantity” and “trend quality” is a very instructive way to frame the discussion about what markets are good for trend-followers. Adam & Yoav wrote an [article](#) on the mathematical distillation of these ideas recently – here we will capture the flavour of those ideas without any of the equations, and show the implications for commodity markets.

Quantity for a Trend-Follower

One measure of trendiness in markets is simply the risk-normalised move that a market makes over the course of several months (typical trend-follower horizons). The higher this measure, the more potential trend there is to be harvested. Whilst we have witnessed the level of trendiness in alternative commodity markets suppressed in the past two years there are three important observations:

1. Even whilst suppressed, the level of trendiness in alternative commodities remains higher than in liquid commodities (which are further suppressed)
2. Over the past 25 years this ‘airgap’ has been consistent – validating our thesis that less financialised alternative commodity markets, which are more exposed to inelastic supply-demand dynamics, demonstrate a higher potential to trend
3. We also see that there have been previous periods of lower levels of trendiness – the recent period is not the new normal

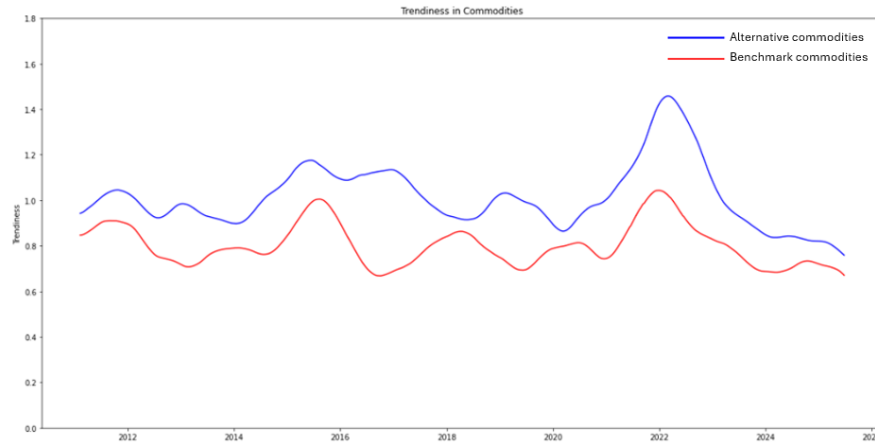


Figure 1. Trendiness in alternative (blue) and benchmark (red) commodity markets over time. Benchmark commodities are from the Bloomberg Commodity Index (BCOM).

Quality for a Trend-Follower

We continue to see alternative commodity markets exhibiting higher levels of trendiness in terms of the *scale* of price move they exhibit over typical trend horizons. But the *shape* of those price moves is also critical in terms of how much of that price move can be harvested by a trend-following strategy. This is the *quality* aspect.

As an example, consider these two rather stylised routes to a market gaining the same amount in a month:

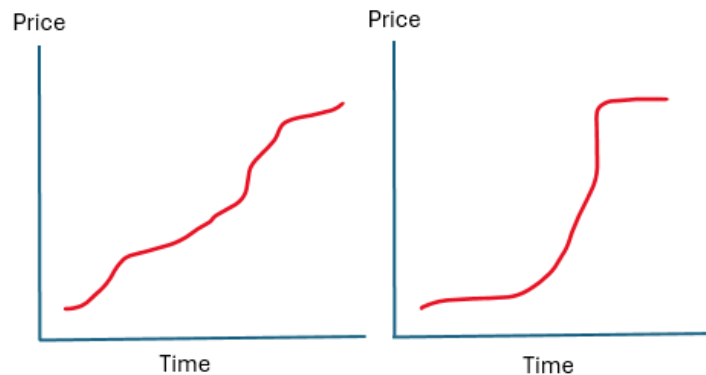


Figure 2. Two paths for the same overall price change. The LHS represents consistent growth, giving a trend follower time to build-up a position. The RHS represents a sudden repricing event.

Whilst the first price action is great for a trend-follower, the second is the exact opposite – a sharp, shock-driven repricing event, where performance depends on your positioning going into the event. A recent example of broad CTA pain would be the Liberation Day events in April of this year. This was a reminder that CTAs are a second, rather than a first, responder. I [wrote](#) about this from the perspective of weather (shocks, noise) versus climate in a recent note.

Can we measure the relative quality of price moves and what implications does that have in terms of how we think about markets in our portfolio?

A way to characterise the smoothness of price changes is via the autocorrelation of the market returns. For a trend-quality measure, one can use a weighted sum of autocorrelations, adopting the same weighting as used in our trend-signals and derive an effective pseudo-Sharpe Ratio.

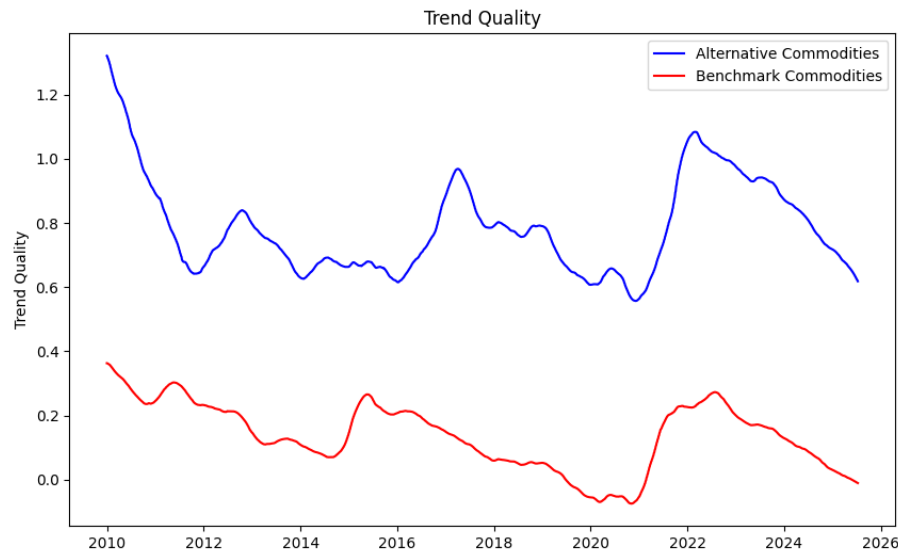


Figure 3. Trend Quality in alternative (blue) and mainstream (red) commodity markets.

As with trendiness, there is a clear higher level of autocorrelation for alternative markets, leading to price moves that are more amenable to being harvested by a trend follower.

Quantity and Quality united!

As promised, an informed choice of which markets to trade leads to both higher trendiness *and* higher trend quality. By turning quality into an objective rather than a subjective measure we can also demonstrate that the way different markets incorporate price changes can lead to trends that are more amenable to harvesting.

(W/H)earth warning

You may now be inspired to go out and collect as many markets as you can that have scored highly for trend quantity and quality. Beware, here be (overfitting) dragons! Rather, you need to identify inherent market characteristics and properties that naturally lead to higher trendiness and trend quality and focus on those instead. Otherwise you may find reality a disappointment when compared to your backtest.